

## Answers to Chairman Gerlach's Question on Alabama's Tax Reform Attempt

A) At the November 29, 2006 meeting of the State and Local Fiscal Modernization Study Commission, Chairman Gerlach asked for information about Alabama's attempt at tax reform. This note describes (as far as I am able to ascertain) events in Alabama, as well as more notable state tax changes since 1987.

B) In 2002, a University of Alabama Law School professor (Susan Hamill) objected to Alabama's income tax on poor households, on ethical and religious grounds. At that time a family of four with \$4,600 or more income was liable for Alabama personal income tax.<sup>1</sup> In response, Governor Riley proposed a change in Alabama's Constitution and tax laws (Amendment One, on Alabama's Sept. 2003 ballot) that would have: increased the income tax threshold from \$4,600 to more than \$17,000, eliminated Alabama's federal income tax deduction, provided property tax relief for small family farms, increased cigarette taxes, increased sales taxes on cars and lawn mowers and on some services (E.G. car repairs). Alabama overwhelmingly voted against Amendment One.

C) Dr. Jim Seroka, Director for the Center for Government Services at Auburn University says Governor Riley's plan would have increased tax revenue by more than \$1.0 billion.<sup>2</sup> When the plan failed, Alabama had to cut state agency appropriations an average of 18%. Seroka reports on a survey he conducted after Amendment One failed. He says of those who voted against the proposal 68% objected to the higher tax on autos and light trucks, 63% objected to increasing Alabama state real property tax assessment to 100% of market value, 61% opposed Governor Riley's plan to increase revenue more than was necessary to balance the budget, and 56% distrusted Alabama's plans to allocate the new revenues. Seroka says of those who supported the proposal, 66% were afraid of teacher layoffs, 52% were afraid of senior center closures, 59% were concerned about unfairness of Alabama's tax system, and 59% liked the promise of a new college scholarship fund based on achievement.

D) In April 2006, Governor Riley signed a law raising the income tax threshold to \$12,600 for a family of four, to take effect in 2007.

E) Additional state tax law changes since 1987 (these are only the ones I am aware of. There probably are many more)

1987: Minnesota: imposed a stamp tax on illegal drugs, and extended its general sales tax to some services.

1989: North Carolina began using federal 'Taxable Income' as its income tax base.

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<sup>1</sup> Alabama's income tax was established in 1935. A married couple received an exemption of \$3,000, with a \$300 exemption for each dependent, giving an income tax threshold of \$3,600 for a family of four (no standard deduction was allowed until 1951). \$3,600 in 1935 had the same inflation-adjusted value that \$37,656.90 has today. In other words, \$3,600 in 1935 bought what it would take \$37,656.90 to buy today. In 1935 Alabama's income tax was paid only by 7,000 high income households.

<sup>2</sup> Seroka, 12/2003, Alabama's Tax Reform: What Went Wrong and Why?  
[http://web6.duc.auburn.edu/outreach/cgs/AllDocuments/SRL\\_Alabamataxvote2003.pdf](http://web6.duc.auburn.edu/outreach/cgs/AllDocuments/SRL_Alabamataxvote2003.pdf)

1990: Massachusetts extended its sales and use tax to business and professional services. It repealed the tax before any revenue was collected in deference to then new Governor Weld, who opposed the tax.

1991: Connecticut enacted a new personal income tax, reduced business income tax rates, and increased some tax credits such as one on capital investment.

Texas “reformed” its franchise tax by making it depend not only on a company's capital stock but also on its net income. It eliminated its corporate income tax.<sup>3</sup>

1992: Colorado amended its constitution, limiting revenue growth to growth in population and the rate of inflation (the “Taxpayer Bill of Rights”). Other states have since passed similar constraints on revenue growth.

1993: Michigan eliminated its local school property taxes.

New Mexico (one of the few states that taxes many services) repealed its sales tax credit for food and medical expenses. New Mexico used the \$20 million saving to increase Medicaid eligibility and aid to low income families.

1994: Michigan amended its constitution to approve a shift in education funding to state sources, reduced the state income tax, increased sales and cigarette taxes, enacted new state property and real estate conveyance taxes, and capped property tax assessment increases.

1995-1998: North Carolina enacted the William S. Lee Quality Jobs and Business Expansion Act, which created business tax credits; phased out the state portion of the sales tax on food; and eliminated its intangibles and inheritance taxes.

1998: In response to a state Supreme Court ruling, Vermont replaced local school district property taxes with a statewide tax on property or income, depending on the type of property and income.

1999: Michigan: passed a gradual repeal of its Single Business Tax [a 23 year phase out with a moratorium if Michigan’s budget stabilization fund (its rainy day fund) falls below \$250 million].<sup>4</sup>

2001: Minnesota eliminated its state general education property tax and created a new statewide property tax on business and seasonal recreational property (dedicated to education).

2005: Voters passed a 5 year override on the revenue growth limits Colorado approved in 1992.

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<sup>3</sup> Steven Gold (Urban Institute) has written that Texas merely renamed its corporate income tax ‘franchise tax.’

<sup>4</sup> The Single Business Tax is one form of Value Added Tax (‘value added’ is the difference between a firm’s total revenue and its cost for inputs purchased from other firms).

New York switched from a four factor apportionment formula to one factor.

Ohio reduced its personal income tax rate from 7.5% to 6%; began phasing out its tax on tangible personal property and inventory, as well as the corporate franchise tax (with exceptions for bank subsidiaries and insurance companies); increased the business real estate tax; increased the sales tax rate; increased its cigarette tax; and enacted a business privilege tax on gross receipts (the "Commercial Activity Tax"). CAT taxes all business receipts. The Ohio Business Development Coalition argues that Ohio's tax reform has worked. [Go to <http://www.ohiomeansbusiness.com/>]

2006: The single most pronounced state tax trend in the past ten years may be the shift from local property taxes to state-wide taxes, to finance schools. Arizona, Indiana, New York, Pennsylvania, and Rhode Island expanded property tax breaks. New Jersey increased sales taxes to finance property tax cuts. Texas and South Carolina raised other taxes to finance property tax cuts.

Indiana will switch to a one factor apportionment formula.

Utah lowered its income tax rate to 5.35% and eliminated deductions. The new "flat tax" is optional. Taxpayers can pay the lower flat tax rate but forego deductions, or can pay a higher rate (6.98%) and take deductions. Tax liability is the lower of the two.

2007: 1,047 online retailers have agreed to begin collecting Vermont's use tax. They will have amnesty from back taxes owed.

Ben Russo